

The Financial Crisis and Asia: Implications for US and Asian Economic Policy Strategies

*Michael G. Plummer,
The Johns Hopkins University, SAIS-
Bologna, and East-West Center*

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Preface

- This presentation is based on work I am doing with Peter Petri at the East-West Center.
- The recommendations I am putting forth are offered as points of discussion, which I very much look forward to tackling with this group (and without inculcating Peter!).

I. The 2008-09 Crisis: Status quo and Prospects

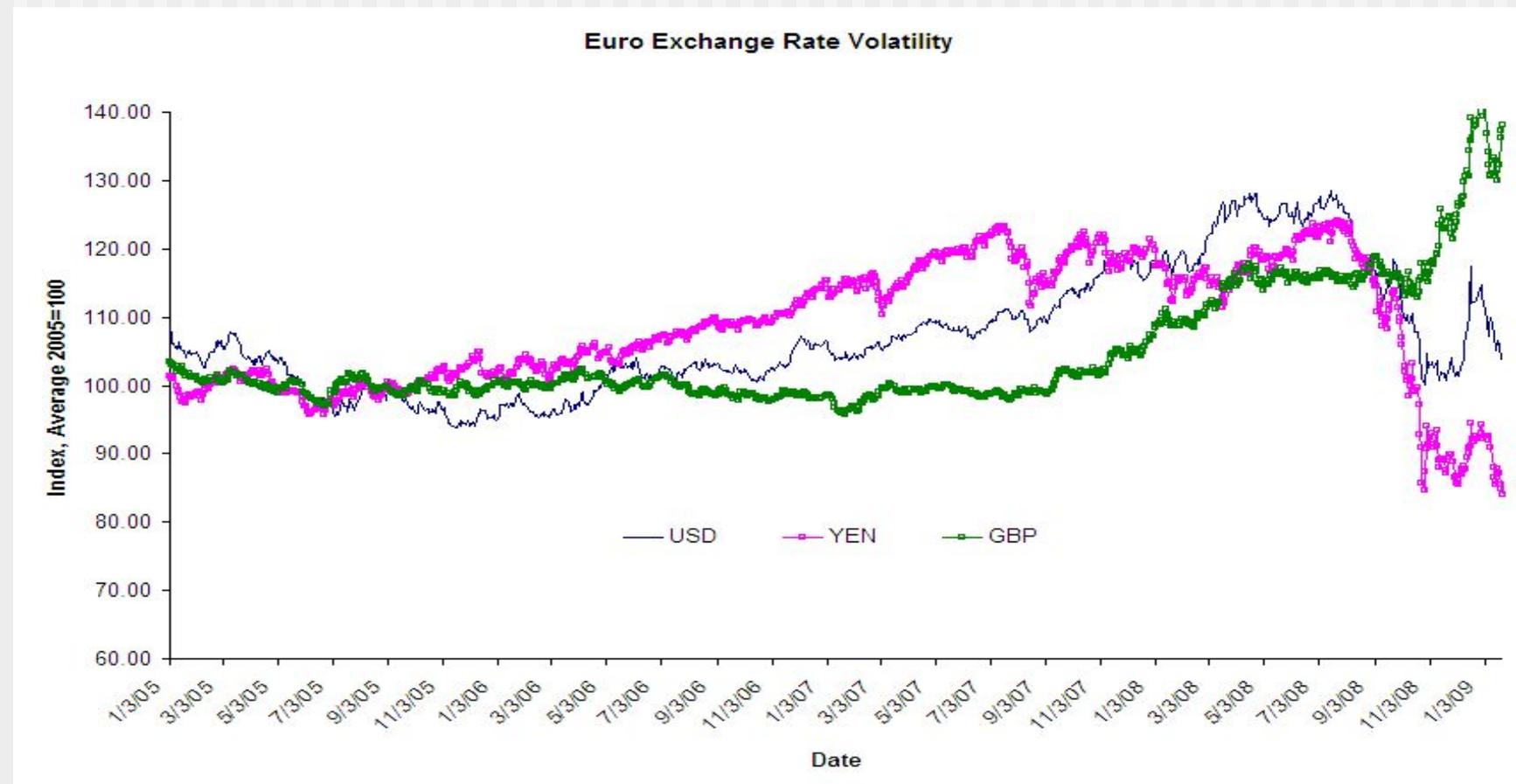
Status Quo

1. I am not going to talk about how we got into this mess; I think that it has been well documented in the press!
2. Suffice it to note that uncertainty in the financial system has never been as high since the Great Depression, or at least the Debt Crisis. The real sector is now feeling the full brunt of the Crisis. It will for some time.

Financial spills over to the real sector

3. Bourses in tail-spin throughout the world with considerable volatility. End-Feb, Dow closed at 7063, down 46% relative to early May 2008.
4. Ironically, US\$ is holding its own, due to US\$ liquidity shortage in, for example, Europe, carry trade unwinding, "safe haven" status, and economic shocks elsewhere. Yen is exception (even stronger carry-unwind effect).
5. US has been in recession since December '07; Eurozone and Japan shortly after. Japan is currently contracting at a 13% pace, only slightly better than its worst-ever. Eurozone is currently in its worst state since the euro (Central and Eastern Europe MAJOR worry).

Exchange Rate Volatility



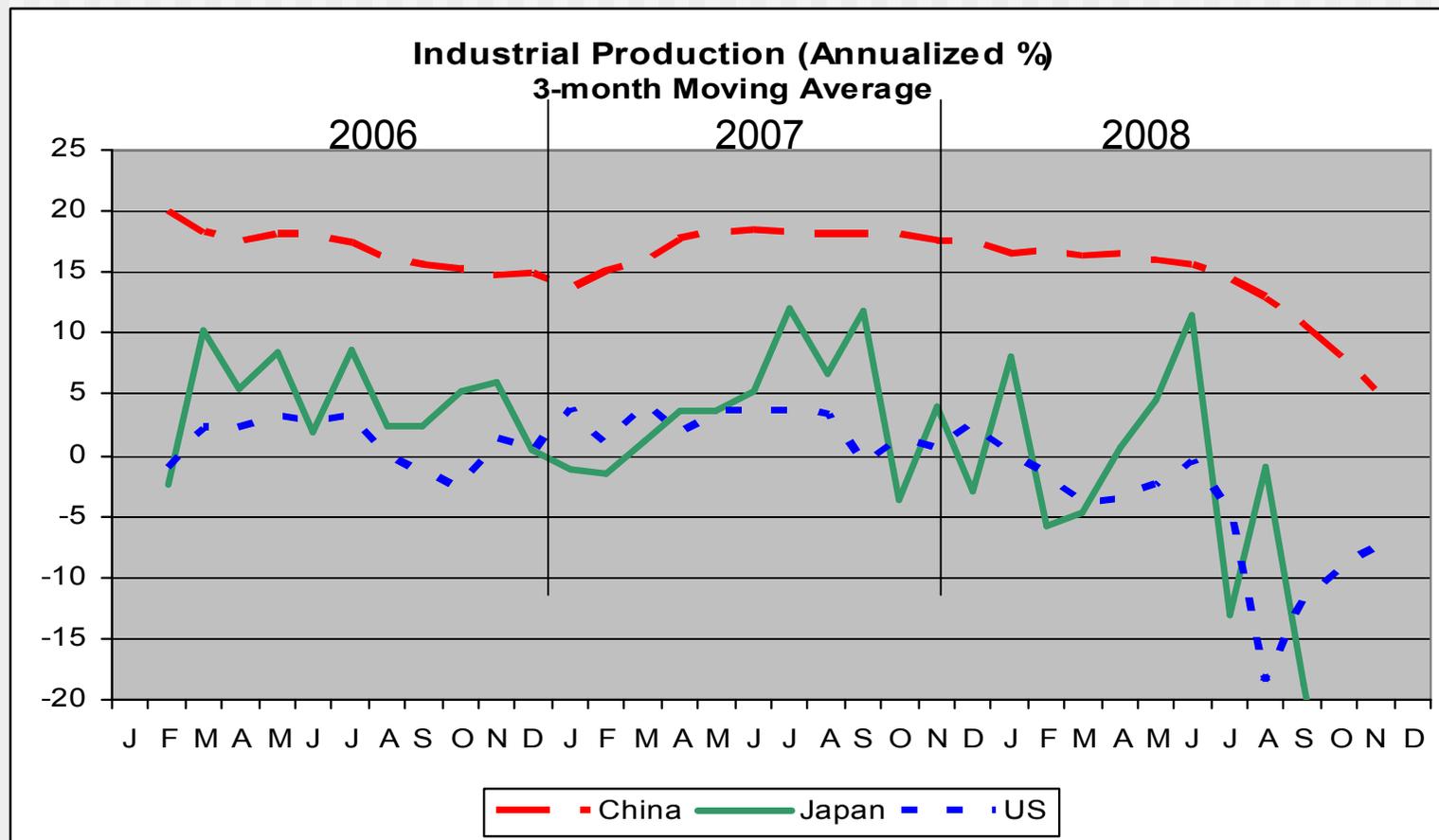
Source: Dutch National Bank

Stock Market Collapse



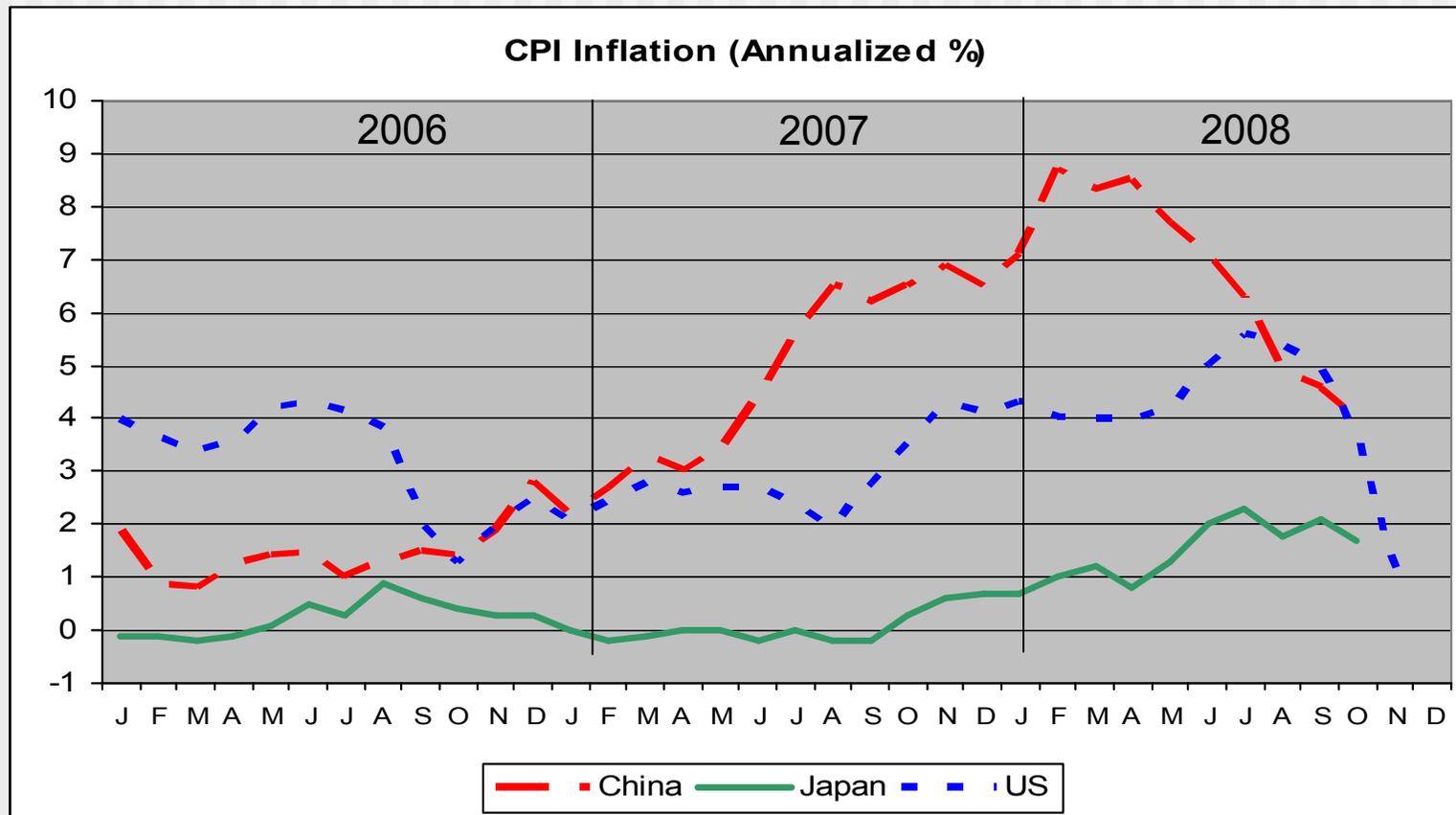
Source: Market Insight

Slowing output



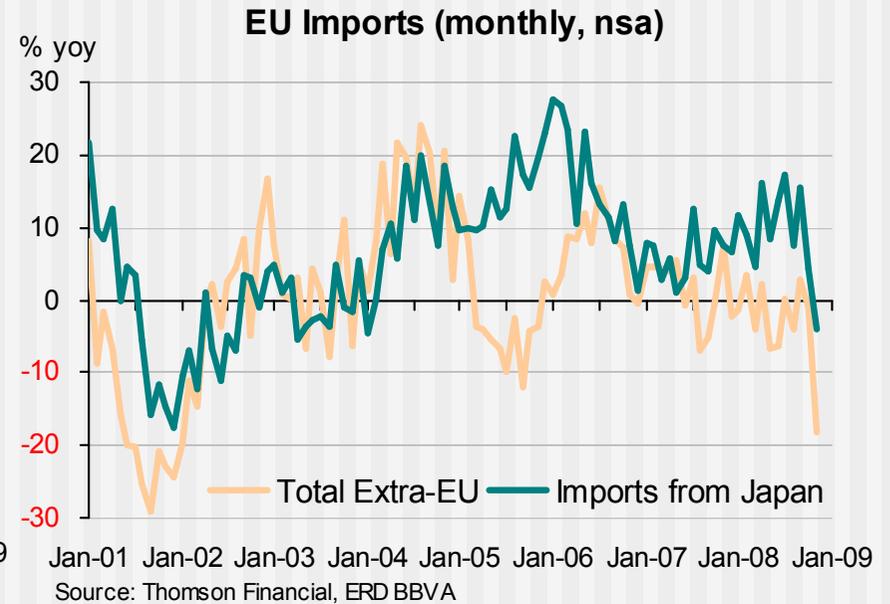
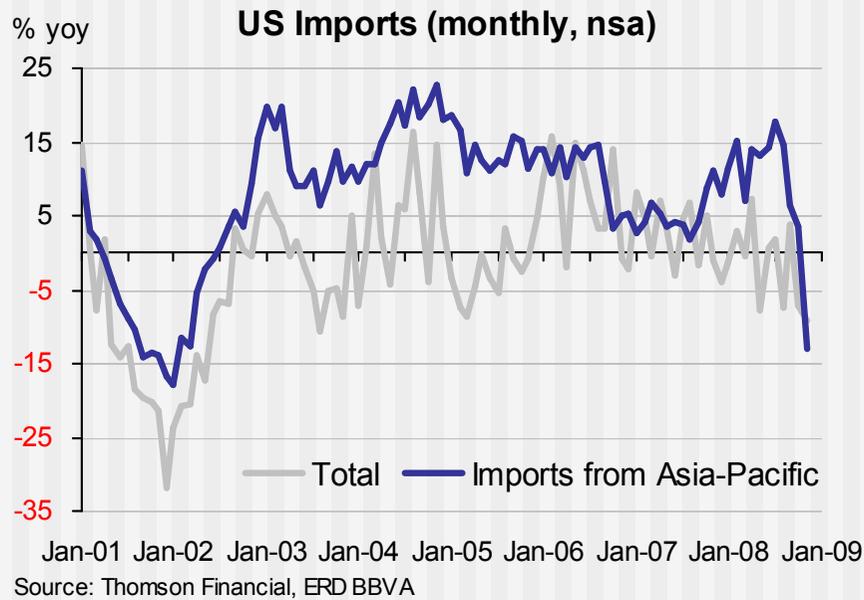
Source: IMF, IFS Database

From inflation to deflation?



Source: IMF, *IFS Database*, accessed 1/3/08.

US and EU Imports



Real GDP Growth Forecasts 2009-2010

(%y/y, as of February 27, 2009)

	2007	2008E	2009F	2010F
Asia ex JPN	9.9	6.7	3.3	6.4
Asia ex J+C	7.2	4.7	-0.6	4.5
China	13	9.0	7.7	8.5
HK	6.3	2.5	-5.6	3.9
India	9.2	7.4	3.8	5.0
Indonesia	6.3	6.0	2.5	4.2
Malaysia	6.3	4.6	-4.5	2.1
Philippines	7.2	4.6	1.7	3.7
Singapore	7.8	1.1	-6.0	3.6
South Korea	5.0	2.7	-4.5	4.8
Taiwan	5.7	0.1	-6.6	4.5
Thailand	5.0	2.8	-6.0	4.5
Memo:				
G3	2.3	0.8	-3.2	0.3
World	5.2	3.4	-0.6	2.7

Source: BNP Paribas

Prospects

1. How deep and long the recession will be depends on many factors. Economic models don't perform well in the context of such uncertainty.

2. I would argue we have more to learn from Japan in the 1990s (and Sweden in early '90s) than the Great Depression. Key lessons:
 - a. Act quickly and decisively in monetary policy and in addressing ills of the financial sector
 - b. Fiscal policy: needs to be expansionary, but spent WELL.

US domestic policy reaction

3. In this sense, Fed has arguably done well: perhaps it has been even too decisive and active. Interest rates near zero; quantitative easing; corporate debt purchases; even long-term US gov't securities possible.
4. Fiscal policy (\$787bill): Stimulus plan is necessary, particularly for "animal spirits". Plan is 63% spending; 37% tax cuts. Flaws? Certainly. Some Pork in spending; some in tax cuts, which are arguably less stimulative anyway. But best that could be done given the economics and politics of the moment.

Dare to Hope

5. In sum, while we might argue about details, the US approach to (domestic) monetary and fiscal policy thus far has arguably been appropriate, though not necessarily optimal.
6. We can expect negative economic data to shower us for at least another six months, barring other major shocks. But all signs are not bad:

Positive signs

- a. Corrections in assets markets already in the range of historical cycles.
- b. Imbalances that contributed to crisis are correcting themselves (hard landing, but still...).
- c. Interbank market has unfrozen; liquidity is there, signs that lending should pick up soon (once things settle).
- d. US consumer prices actually rose by 0.3 percent in January, relieving fears of potential deflation.
- e. Retails sales up (1%) from Dec.-Jan.
- f. Car sales fell last month but have stabilized.
- g. Q4'08 GDP growth revised down to 6.2%, half due to big investory drop. Sign of stabilization?
- h. Some think that the economy will actually shrink by less in Q1'09 (Economist) than in Q4'08. Updated (Feb. 21 '09) Commerce Dept, WSJ Survey: Positive growth in Q3'09 (0.9%) and double that (1.9%) in Q4'09.

Historical Experience

7. Claessons et al. (historical: OECD, QI60 to QIV07, severe recessions):
 - a. Peak to trough recessions last 4 $\frac{3}{4}$ quarters (in line with Asian Crisis, for example).
 - b. % loss in GDP from peak to trough: 5%
 - c. House prices peak to trough: 18 quarters (we're in about 7th quarter).
 - d. Equity prices peak to trough: 12 quarters (we're in 4th, but bubble was arguably historically small).
- *Conclusion:* Relative to historical average, output due to turnaround. Other variables still need time.
- But this is not a traditional "severe" recession!

Perspective

8. Hence, don't get me wrong: we cannot discern a trend from few months of data, or impose the assumption that past determines future. Still much uncertainty; if I were to list all the negative data, we'd be here all morning. But the sky is not falling and capitalism is not finished.
9. Whether it will be long or short will depend not only on the success of the domestic policies mentioned earlier, but the US and international approaches to addressing the Crisis.
10. We argue in this piece that the myriad challenges facing the US and Asian governments in this period underscore the need for cooperation at regional and global levels.

II. US and Asian International Economic Policy Challenges

Summary of Challenges

1. The US and Asian governments face the following short-medium term challenges:
 - a. Real-sector-related (trade, FDI):
 - i. Avoid the “usual” urge to protect.
 - ii. Finish a “deep” Doha accord.
 - iii. Devise an effective FTA strategy, including FTAAP and deeper subregional accords.
 - iv. Deal with trade finance and related issues.

Macro-Finance-related

- b. Macro and finance-related:
 - i. Optimal mix of interventions; discover more effective approaches to coordinated economic policy in all areas.
 - ii. Fix imbalances that arguably fed Crisis (Macro, CA imbalances in particular).
 - iii. Exchange-rate volatility.
 - iv. Reform of international economic institutions.

Announcements: "Big 3"

	China	Japan	US
Fiscal policy	<ul style="list-style-type: none"> • \$586b package • reduction of the down payment on first homes • cuts in mortgage rates • reduce VAT on land sales • Tax rebates raised on 3,486 industry items 	<ul style="list-style-type: none"> • \$132b package 	<ul style="list-style-type: none"> • \$787b package
Monetary policy	<ul style="list-style-type: none"> • Reduction in lending rates to 5.31% • Reductions in reserve requirements • Tax exempt bank dep. 	<ul style="list-style-type: none"> • Zero short term rates 	<ul style="list-style-type: none"> • \$800b in Federal Reserve special facilities • Zero short term rates
Trade Policy	<ul style="list-style-type: none"> • Reductions in export taxes • Agricultural export controls 		
Intervention	<ul style="list-style-type: none"> • CIC took positions in banks 	<ul style="list-style-type: none"> • \$110b bailout? 	<ul style="list-style-type: none"> • \$700b+ financial bailout
Int'l instit.	<ul style="list-style-type: none"> • CMI expansion (\$120b) 	<ul style="list-style-type: none"> • \$100 billion to IMF • \$3b to World Bank • CMI exp. (\$120b) 	

Other Stimulus Announcements

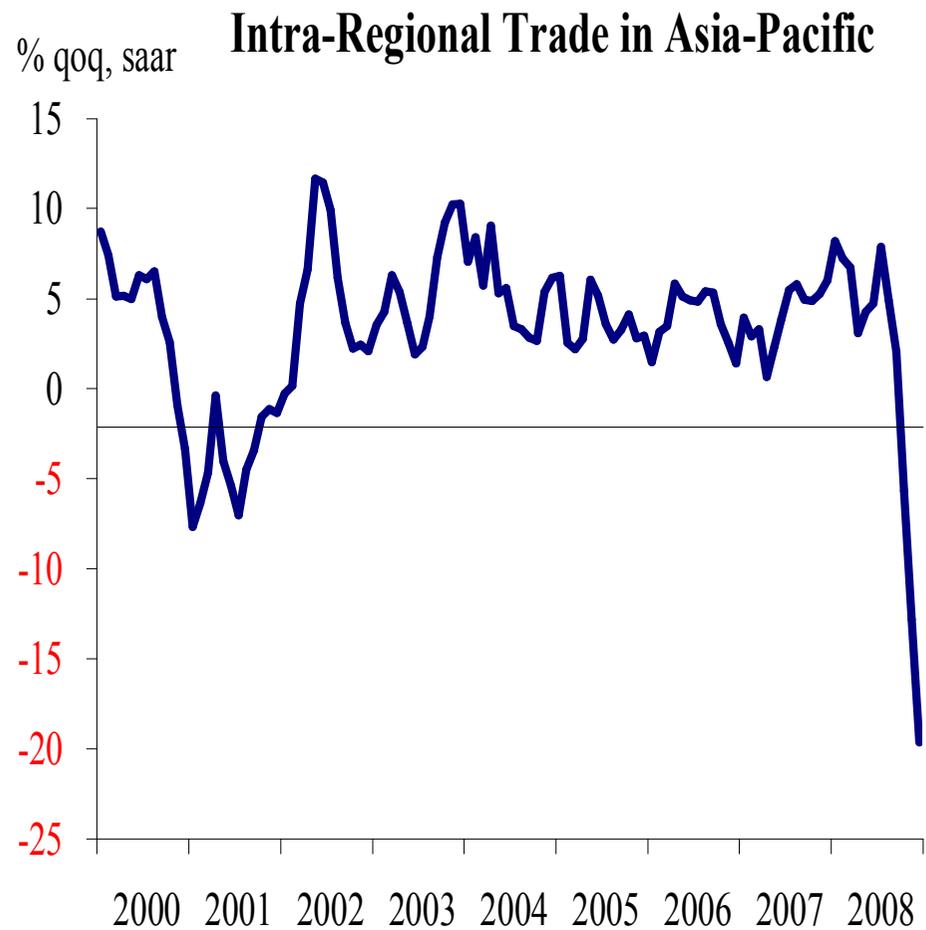
- Large stimulus packages: Singapore (\$13.8 b); SK (\$11 b in Nov; “Green Stimulus” in Jan of \$38b).
- Other relatively large: SK (\$11 b); Thailand (\$8 b); Philippines (\$6 b); Indonesia (\$6 b).
- Malaysia: Only \$2 billion (despite forecast of GDP growth forecast of -4.5 for '09).
- Concerns everywhere that money is not being disbursed quickly enough. Time inconsistency problem?

Challenges Facing Regional Asian Policy

2. Asia-specific challenges:

- i. How to deepen regional integration in times of such uncertainty?
- ii. H 0
 - a. stimulate domestic demand (rely less on net exports)
 - b. Exchange-rate cooperation

Growth in Intra-Asian Trade



Source: ERD BBVA estimates

Effects of Crisis on Cooperation (Plummer 2009)

Motivations for Economic Cooperation and the 2008 Crisis: Taxonomy of Links

	Real-sector Coop	Financial Coop.	Effect of Crisis
Market Efficiency and Competitiveness:			
*Micro efficiency in real sector	√	√	+
*Economics of scale	√	√	+
*FDI/technology/new markets	√	√	+
*Trade creation	√	0	-
*Trade diversion (political)	√	0	+
*Micro efficiency in finance (e.g., asset mkt building)	0	√	+
Policy considerations:			
*Macro stability (e.g., ASEAN surveillance)	0	√	+
*Macro support (e.g., CMI, Asia Fund, even mon. union)	0	√	+
*"Defensive"/reactive (e.g., regional identity, "in it alone", nationalism)	√	√	+/-

III. Channels of Cooperation

The Need for Int'l Cooperation

1. The current crisis has revealed the need for better channels of international cooperation. US and Asia are key players:
 - i. As globalization has progressed, approaches to governing and managing it have lagged.
 - ii. Example: no international monetary system (\$/€, \$/yen!).
 - iii. Example: no new trade deal, but demands of globalization have sparked regionalism trend.
 - iv. Example: we have no mechanisms in place to harness int'l approaches to crisis. This has certainly reduced our effectiveness in dealing with relevant issues.

Suboptimal response to Crisis

2. At the global level, most major economies are responding to the crisis, but not in a coordinated way.
 - In Europe, picture is mixed: France, UK, and Germany, rather large injections. Others less so (including Italy) for various reasons.
 - Differences regarding how much to help Central and Eastern EU members (and non-members) presenting key test of unity, as has “nationalistic” response in some quarters.
 - “Free-rider” problem and inefficiencies regarding cooperation.

Policy spillovers and externalities

3. For example:

- Policy spillovers may lead to “bad” equilibria
- Joint commitments may be more credible
- Uncoordinated regulation may lead to arbitrage
- Direct intervention could have competitive effects (e.g., autos)

Policy spillovers (Petri and Plummer 2009)

<i>Type of Policy</i>	Problem targeted	Remedy	Outward Spillovers	Side effect
Fiscal policy	Inadequate demand	Spending	Demand leakage	+
Monetary policy	Inadequate liquidity	Easing	Boost liquidity	+
			Depreciation	-
Trade policy	Inadequate demand	Protection	Declining trade	-
Regulation	Loss of confidence	Oversight	Regulatory arbitrage	+
Intervention	Loss of confidence	Bailouts	Boost confidence	+
			Boost competition	-

What needs to be done?

- Sustain global public goods: IMF, trade
- Generate adequate fiscal and monetary stimulus
 - Uncoordinated may be insufficient
 - Uncoordinated may not address imbalances
- So, with view to stimulate growth and improve imbalances:
 - China, NIEs and ASEAN-5 should stimulate domestic/regional demand
 - Japan should stimulate domestic expenditure but contain debt
 - US should allow consumption decline while stimulating domestic supply
- Complicated policy mix requires coordination
- Crisis can be used as a means to enhance cooperation in these and other areas (without concerted effort, could go other way)

IV. Recommendations for the US-Asia Approach to Crisis and Beyond

Recommendations: Global level (real)

1. There is much that US and Asian governments can do together to address the current crisis and build strong foundations for the future:
 - I. Global level:
 - i. Commitments to resist strong political motivation for “beggar-thy-neighbor” policies, e.g., trade protection, “Buy USA”.
 - ii. Coordinate rules, even *ad hoc*
 - iii. Place a high priority on finishing the Doha Development Agenda.

Recommendations: Global level (macro/finance)

- iv. Better coordination of Crisis response (discussed above)
- v. Work to create a coherent international monetary system.
- vi. Develop “common-denominator” rules (or rules-of-thumb) to govern finance (at minimum, “internalize” financial externalities through better governance, surveillance).
- vii. Major cause of Crisis: imbalances. Need to ensure “soft landings”. *Inter alia*, put in place indicators of macro problems (e.g., à la ASEAN Surveillance).
- viii. Redefine roles of BW financial institutions in light of new global economy.
- * I would argue that we might best address these through a “Bretton Woods II Process”

Recommendations: US-Asia Regional

Our suggestions for US-Asia:

1. Forge common stand on global issues (e.g., Doha).
2. Imbalances have emerged especially across the Pacific; continued commitments to sustain and enhance openness.
3. Continue deepening of bilateral and regional cooperative programs (e.g., ratify US-SK; renew efforts at US-ASEAN).
4. US should continue to support AEC efforts (2015 was always ambitious; even worse with Crisis).
5. Begin long road to developing an FTAAP.

Difficult, but Cause for Optimism

- I realize that these are ambitious recommendations. But in crisis there is opportunity, and no time like the present.
- The fact that the Obama Admin sent Clinton to Asia as her first trip abroad underscores commitment to the region.
- An active, effective Asia policy could define success of the Obama Administration in int'l cooperation.
- Asia should support the new Administration as it goes down this path, taking into account both econ and political challenges it faces.